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SUBJECT: PM AND FINANCE MINISTER ON PAKISTAN'S TROUBLED ENERGY SECTOR

REF: ISLAMABAD 1983

**¶1.** (SBU) Summary: In meetings with Prime Minister Gilani and Finance Minister Tarin, NSC Senior Director for International Economics David Lipton said Pakistan needed to take a number of steps in the coming months to put its energy sector on firmer footing: resolve the remaining \$3.7 billion "circular" overhang of energy sector inter-corporate and bank debt; ensure that energy tariff's are adjusted to cover energy generation and distribution costs, as agreed to with the ADB and World Bank and blessed by the IMF; and create an energy sector task force to prioritize and implement short-term projects to limit blackouts and unscheduled load shedding through improved generation and distribution. Tarin said the circular debt would be resolved by August 31, through the placement of \$2.6 billion of old debt into a holding company and a \$1.1 billion capital injection for current arrears. Gilani said the GOP would stick to its commitment to raise tariff rates and said a ministerial-level task force was meeting daily to address the energy sector. Gilani welcomed the proposed October 21-22 strategic energy dialogue.

**¶2.** (SBU) Lipton warned Gilani and Tarin that banks, overloaded with GOP and energy sector debt, planned to cut credit lines to the power sector, squeezing power producers' ability to secure fuel stocks and perform essential maintenance and repair. Tarin said he would work with State Bank of Pakistan (SBP) Governor Raza to persuade banks to keep credit lines open. Lipton noted that public opinion could turn against tariff increases because of the GOP's approval of 14 expensive rental power projects, some of which may questionable merits. Tarin agreed with Lipton's suggestion that independent auditors should review the rental power agreements to dispel public criticism. End Summary.

Resolving Pakistan's Circular Debt

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**¶3.** (SBU) In an August 28 meeting, Tarin said that \$2.6 billion of energy sector circular debt had been placed in the Government Power Holding Company, a newly-created GOP debt holding company. As further detailed reftel, circular debt is inter-corporate and bank debt that accrued from

non-payment between various energy companies as a result of insufficient tariff collection and non-payment of government subsidies. Tarin hoped to repackage the holding company debt as bonds for sale to domestic and overseas markets. (Note: Currently, there is no secondary bond market in Pakistan, though the State Bank of Pakistan(SBP) and Karachi Stock Exchange (KSE) are working to develop one. End note). Tarin said the GOP injected an additional \$850 million in the sector on August 28 to erase more recent arrears and planned to inject another \$240 million on August 31. The injections were financed through five-year term finance certificates (TFCs) with a sovereign guarantee placed in domestic banks. (Note: The Asian Development Bank (ADB), which closely follows the circular debt issue, could not confirm these figures. Post will report on the amount of arrears actually removed from the sector septel).

¶4. (SBU) Lipton reported that a number of banks, overloaded with government and energy sector debt, planned to cut lines of credit to the power sector, further squeezing power producers' ability to secure fuel stocks and finance necessary repairs and maintenance. He asked that the Ministry of Finance and SBP work with the banks to keep credit flowing so that power producers had the financial wherewithal to bring additional power on the grid before the October 1 tariff increase. Tarin said that power producers would not need large credit lines, as the financial injection would erase their arrears, but agreed to ensure the banks extended appropriate credit lines to the sector.

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#### Tariff Increases

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¶5. (SBU) In an August 28 meeting, Prime Minister Gilani reiterated his long-standing assertion that the political opposition and the public would accept tariff increases if they saw new power coming on the grid. (Note: The GOP agreed to a World Bank/ADB plan to raise tariffs 6 percent on October 1, 12 percent on January 1, 2010, and 6 percent on April 1, 2010. End Note). Gilani said his government was put in the unenviable position of correcting energy policy mistakes of previous administrations. Minister of Water and Power Raja Ashraf added that the GOP had tried to push through a 17.5 percent tariff increase in June but reversed itself in response to public outcry. Gilani said, however, that a consensus had been built on energy and that opposition PML-N leader Nawaz Sharif supported his policies. He said additional generation would be on the grid by December, reducing blackouts and public opposition to the tariff hikes.

#### Rental Power Projects

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¶6. (SBU) Tarin said he had opposed the August 24 GOP decision to approve 14 rental power projects with a total installed capacity of 2250 MW. (Note: Rental power was conceived as a stop gap measure to increase power generation. Rental power producers (RPPs) agreed to quickly install refurbished equipment to deliver power for three to five years. Though the official cost per kw/h for RPP power is only 1-2 cents higher than that of long-term independent power producers (IPPs), the structure of the RPP contracts pushes the actual kw/h costs higher. There have been accusations of corruption in the awarding of RPP contracts. End note.) Lipton said that public opinion could turn against tariff increases if RPP contracts were not perceived as transparent and fair. Tarin said he acquiesced to the 14 rental projects only after Gilani promised him that the GOP would raise tariffs as scheduled and allow a third-party auditor to review the RPP agreements. (Note: The ADB confirmed that the Ministry of Finance requested it arrange the audits. The ADB has yet to decide whether to do the audit itself or contract with an outside firm. End note.) Tarin also said he would not direct banks to finance the

RPPs, noting loans should be based on each project's financial merits.

Energy Sector Planning

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¶7. (SBU) Lipton urged Gilani to put a working-level energy task force in place that could prioritize and implement short-term repair and maintenance projects to improve existing power generation and distribution. Gilani said he had already instituted a daily ministerial-level task force. Minister for Water and Power Ashraf added that the GOP had a short-term and medium-term energy plan. (Note: None of our other energy interlocutors had heard of such a plan. End note.) Tarin said a working-level task force that reported to a ministerial committee biweekly would be an effective means to improve the sector's performance. Gilani welcomed a U.S.-Pakistan strategic energy dialogue on October 21-22.

¶8. (SBU) Comment: The clearing of the circular debt is an important first step in getting Pakistan's energy sector on firm footing, opening the financial space for short and long-term investments in generation and distribution. Much now depends on the GOP's commitment to raise tariffs, as well as paying out necessary subsidies to the energy sector until the payment gap is closed. Adherence to the October 1 tariff increase would signal to the banking community that the GOP is serious about energy sector financial reform and could help loosen up credit lines. However, continued load shedding and rising public suspicions about rental power

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could well combine and derail tariff reform. End Comment.

¶9. (U) This cable was cleared by NSC Senior Director for International Economics David Lipton.

PATTERSON